SUMMARY

INTRODUCTION

Many taxpayers and tax policy analysts are dissatisfied with the current individual income tax. They perceive that it is complex and unfair and that it impedes productivity and distorts economic decisions, particularly those concerning saving and investment. Although there is little agreement on the best remedy, considerable support exists for elimination of tax deductions, exclusions, exemptions, and credits in exchange for a significant reduction in marginal tax rates, including collapsing the current twelve tax brackets to three or four or to one "flat" rate. Many bills have been introduced in the Congress for these kinds of changes, generally called broadening the income tax base and reducing tax rates.

Although most public attention has focused on broadening the income tax base and reducing tax rates, economists have given considerable attention to two other ideas for major change: taxing consumption instead of income and indexing the income tax base (capital gains, interest income and expense, depreciation, and inventories) to eliminate the effects of inflation. The income tax base could be broadened with or without tax-base indexing.

The three reform proposals would have different revenue effects. Comprehensive income tax base broadening would allow significant reductions in tax rates while maintaining the same revenue yield. Rates would have to be somewhat higher under a consumption tax than under an equally comprehensive income tax in order to achieve the same overall revenue yield. Elimination of the corporate income tax would require higher rates under either an individual income or consumption tax to maintain the combined yield of the taxes. Indexing the income tax base for inflation would reduce revenues unless accompanied by elimination of tax preferences. This study summarizes the advantages and disadvantages of these three approaches to reform of the individual income tax system.

Broadening the Income Tax Base and Reducing Tax Rates

The many current tax deductions, exclusions, exemptions, and credits (called tax preferences or tax expenditures) complicate the income tax and, in many ways, contribute to its perceived unfairness. Because there are so many tax preferences, certain kinds of income are essentially exempt from tax, leading to higher tax rates on the income that is taxed in order to raise the total desired amount of revenue.

High marginal tax rates induce taxpayers to seek legal and illegal ways to reduce their taxes. Because of the profusion of tax preferences, taxpayers with equal incomes pay widely different rates of tax, and most taxpayers feel that higher-income individuals are better able to use the preferences and so escape their fair share of the tax burden. At the same time, the complexity of the tax imposes heavy costs on all taxpayers and the Internal Revenue Service (IRS), and high marginal tax rates may discourage work effort and saving and cause the tax system to play a pronounced role in influencing investment decisions. The problems caused by high marginal tax rates and the proliferation of tax preferences could be addressed directly by broadening the income tax base and using the additional revenue to reduce tax rates.

Consumption Taxation and Income Tax Base Indexing

Many economists endorse consumption taxation or indexing the income tax base because they believe that the current tax distorts investment decisions and may discourage saving. The return from saving is now taxed at widely varying rates. Some earnings, like interest on municipal bonds, are exempt from tax, while the return on some tax-sheltered investments is essentially subsidized through the tax system and taxed at negative rates.

The uneven taxation of the return from saving is caused not only by tax preferences but also by inflation, which distorts the measurement of depreciation, interest, capital gains, and inventories, since tax is imposed on nominal rather than real changes in worth. As a result, inflation unevenly increases taxes on capital income. The real return on some capital gains and interest income is even taxed at rates above 100 percent. Partly in response to the effects of inflation, but more in an effort to encourage additional saving and investment, the Congress has enacted many tax incentives for saving and investment over the past few years. For instance, it raised from 50 to 60 percent the portion of long-term capital gains that are excluded from taxation, expanded Individual Retirement Accounts and Keogh accounts, and significantly liberalized depreciation rules. While these changes reduced the overall rate of tax on capital income, they may have worsened the unevenness in the tax rates applying to different kinds of saving and investment. Since investment dollars flow to the highest after-tax returns, a wide dispersion in tax rates on different investments causes a misallocation of investment resources and reduces the total national output below its potential.

Exempting all saving from taxation would encourage saving uniformly. Since a consumption tax is an income tax with an exemption for saving, it would reduce to zero the tax rate on all saving and eliminate the current distortions that favor some forms of saving and investment over others.

As an alternative to a pure consumption tax, the income tax could be retained, but the tax on all saving could be imposed at exactly the statutory tax rates. This could be accomplished by eliminating existing tax preferences for saving and investment and indexing for inflation the measurement of capital income in the income tax base. This would raise tax rates for investment currently receiving preferential tax treatment and reduce tax rates for investment currently receiving unfavorable treatment. Some advocate indexing the income tax base and retaining tax preferences for capital income as an intermediate approach between pure income and consumption taxation.

Criteria for Evaluation of Options

The three approaches to reform the current individual income tax--broadening the income tax base and reducing tax rates, indexing the income tax base for inflation, and taxing consumption instead of income--can be evaluated according to three criteria: simplicity, efficiency, and equity. Simplicity is gauged by ease of comprehension, tax planning, compliance, and IRS administration. Efficiency is measured by the degree to which the tax distorts the allocation of economic resources among investments and time periods and affects decisions on work and saving. Equity is determined by how fairly the tax treats those in similar economic circumstances and distinguishes among those in different circumstances.

BROADENING THE INCOME TAX BASE AND REDUCING TAX RATES

Comprehensive broadening of the income tax base would entail repeal of nearly all tax deductions, credits, exclusions, and exemptions, including, for instance, the deductions for charitable contributions and medical expenses and the exemptions from tax of government transfer payments (such as Social Security and Aid to Families with Dependent Children), fringe benefits, and interest on municipal bonds. Costs of earning income would continue to be deductible, so that net income, rather than gross receipts, would be taxed. With a comprehensive income tax base, tax rates could be much lower than current rates without changing the total yield of the tax.

Marginal Rate Reduction

Reducing tax rates substantially would have beneficial effects, whether the resulting tax had a single, flat rate or a new set of graduated rates. If the base was broadened and the rates reduced to a new, lower set of graduated rates, most taxpayers would face lower marginal tax rates, although some taxpayers who now make heavy use of tax preferences would face higher tax rates. If a single flat tax rate was adopted, many middle-income taxpayers would face somewhat higher marginal tax rates than they currently do, while many high-income taxpayers would have their marginal tax rates reduced substantially (by up to 20 percentage points). Some of the benefits of rate reduction for those facing lower rates would be offset, therefore, by the losses for those facing higher rates.

High marginal income tax rates impose a price in terms of reduced economic efficiency. Because the second member of a family to enter the labor force often faces particularly high tax rates under the current graduated-rate tax, work effort of these people, typically married women, is discouraged. (The first dollar earned by the second worker is taxed, in effect, starting at the tax rate on the last dollar of income of the first worker. The high tax rates on second workers were reduced somewhat by the two-earner deduction enacted in 1981.) Recent evidence suggests that even married men, long felt to be relatively unaffected by high tax rates, would desire to work 5 to 10 percent more hours per week if a broad-based, flat-rate income tax was adopted. With lower marginal tax rates, taxpayers would probably save more, pay more of the taxes they owe, engage in less barter of goods and services, prefer more remuneration in wages rather than fringe benefits, and invest more productively with less regard to tax considerations.

Reducing tax rates would simplify the tax code, especially if one flat rate was adopted. Less time and effort would be spent arranging to have income taxed at lower rates (after retirement, for instance, or to children), and there would be less need to allow taxpayers to average their incomes over several years. Under a flat-rate tax, inflation would no longer cause bracket creep (except for the relatively small amount caused by the personal exemption), although it would continue to distort the income tax base through effects on capital income, unless the base was indexed for inflation. A flat-rate tax could be designed to eliminate marriage bonuses and penalties, and a less progressive set of graduated rates would reduce them.

Obviously, an income tax with graduated tax rates is more progressive than a flat-rate tax with the same personal exemption, although even a flat-rate tax with a personal exemption is somewhat progressive because average tax rates rise somewhat with income. Whether a flat-rate or graduated-rate tax is more equitable cannot be proved, but must be decided subjectively by the public and their legislative representatives, according to their assessments of the degree to which taxes should be used to redistribute income and of the degree to which the ability to pay tax increases with income.

Income Tax Base Broadening

Equity. Since broadening the tax base to eliminate tax preferences would reduce the wide variation in effective rates of tax within income groups, it would improve equity. On the other hand, repealing some of the preferences, such as the deduction for medical expenses and the extra exemption for the blind, might be perceived as lessening equity.

Efficiency. Economic efficiency would improve if the tax base were broadened to include income from all sources. In particular, the allocation of economic resources among investments would improve and national output would increase as investment decisions were influenced less by tax considerations. Elimination of tax preferences for saving might discourage saving, however, unless it was accompanied by substantial reductions in marginal tax rates.

Simplicity. Eliminating tax preferences would simplify the tax code, but taxing income not now covered would complicate it. Taxing transfer payments would bring more taxpayers into the system, unless personal exemptions were liberalized. Taxing other income--for example, fringe benefits, accrued life insurance, and imputed income from owner-occupied housing--might pose difficult valuation problems.

General Conclusions About Base Broadening and Rate Reduction

Unresolved Problems. Some lightly taxed income would probably continue to be lightly taxed under base broadening, because taxing it fully would require that assessments of value be made in the absence of market transactions. In this category is income from the use of owner-occupied housing and consumer durables and from services provided by an unpaid homemaker. Full taxation of capital gains and pension income is feasible but would be administratively complex.

Mismeasurement of the income tax base would continue during inflationary periods, unless the base was indexed for inflation. Unless business tax preferences were eliminated along with personal tax preferences, opportunities to shelter income from taxation would remain, although tax rate reduction would make tax shelters less lucrative.

The double taxation of dividends--which discourages the corporate form of doing business, encourages debt as opposed to equity financing, and encourages retention of corporate earnings--would remain. This could be eliminated by the integration of corporate and individual taxes through the abolition of the corporate tax and taxation of stockholders' respective shares of corporate income. Complete integration, however, would be difficult to achieve under any graduated-rate income tax because of the difficulty of imputing annual retained corporate earnings to shareholders.

Transitional Problems. Even with phase-ins or grandfathering, a new comprehensive income tax would impose large windfall losses on owners of assets that currently receive preferential tax treatment and corresponding windfall gains for owners of currently unfavored assets. It would also adversely affect groups like charities and state and local governments that benefit from tax preferences. Graduated tax rates could be adopted so that the average tax paid by each income group would be about the same as under current law. Even so, under a comprehensive income tax, taxpayers who now make relatively little use of tax preferences would pay much less tax, while heavy users of tax preferences would pay more. A study that compared the 1976 income tax with a hypothetical broad-based income tax of equal yield and overall progressivity found that under the new tax roughly 23 million taxpayers would have faced tax increases greater than both $100 and 10 percent of their 1976 tax liabilities.

Hypothetical Flat-Rate Taxes. The Joint Committee on Taxation estimated that a flat tax rate of about 12 percent would raise the same amount of revenue in 1984 as the current individual income tax if the tax base was expanded by taxing all nominal capital gains in full and eliminating all personal exemptions, tax credits, and deductions, including the standard deduction. A flat rate of about 18.5 percent would be needed to raise this amount of revenue without eliminating any deductions, exemptions, or credits or in any other way changing the current tax base.

Under the current progressive individual income tax, average tax rates projected for 1984 range from about 5 percent for those with incomes between $5,000 and $10,000 to about 25 percent for those with incomes above $200,000. This degree of progressivity could be replicated with a lower set of graduated marginal tax rates applied to a broader tax base, but not with one flat rate. The flat tax rate would probably be between 15 and 20 percent, so that those high-income taxpayers currently paying higher average rates would get large tax cuts, and taxpayers currently paying lower rates would receive tax increases. The personal exemption would probably be set higher than it is currently in order to protect the lowest-income taxpayers from large tax increases. At the single tax rate that would then be needed to raise current levels of revenue, middle-income taxpayers would, on average, pay more tax than they now do.

INDEXING THE INCOME TAX BASE FOR INFLATION

The Problem

Inflation causes two distinct problems for an income tax, and each requires its own kind of indexing. The first--bracket creep--is caused when rising nominal incomes push taxpayers into higher tax brackets even though their real incomes have not changed. This problem will be eliminated with bracket indexing, a version of which goes into effect in 1985 as enacted in the Economic Recovery Tax Act of 1981.

In contrast to bracket creep, which affects income from labor and capital equally, the second inflation-caused problem affects only income from capital. Since investment expenditures are made before the resulting receipts, failure to measure capital expenditures and receipts in dollars of the same purchasing power causes capital income to be overstated and hence overtaxed during inflationary periods, even if tax brackets are indexed. Tax-base indexing would convert investment receipts and the costs of earning them to dollars of the same purchasing power, so that when expenditures are subtracted from receipts to calculate taxable income, the result would be an accurate measure of real income. Tax-base indexing would entail indexing capital gains, interest income and expense, depreciation, and the cost of production inputs taken from inventories.

Capital Gains. Tax is currently imposed on 40 percent of nominal long-term capital gain, which is the difference between the sale and purchase price of an asset, and is due only at sale, rather than annually during the course of ownership, whenever appreciation occurs. Some tax is collected on the sale of assets that have appreciated at or less than the inflation rate and that have experienced no gain in real value. Capital gains indexation would exempt from tax the portion of nominal gain needed to maintain the purchasing power of an initial investment, so that no tax would be due on the sale of assets whose prices just kept pace with inflation. The indexed capital gain on which tax would be due would be the sale price of an asset minus the purchase price adjusted for inflation.

Interest Income and Expense. All nominal interest income is currently taxed, even though much--sometimes most--is not real interest at all, but rather the amount required simply to maintain the purchasing power of the lender's principal. As a result, the rate of tax on real interest income can exceed 100 percent during inflation, so that some of a lender's principal as well as all of his real interest is collected in tax. The taxation of principal is worst during times of high inflation and for investors in the highest tax brackets. By the same token, because taxpayers are allowed to deduct all nominal interest paid, in many cases they can deduct much more than 100 percent of real interest paid, so that the government, in effect, pays part of the loan principal through the tax system.

If interest income and expense were indexed for inflation, only real interest payments would be taxed and deducted, and the portion of interest that accounts for inflation would be left out. An imprecise, but fairly simple, approximation of interest indexation would be to tax only a specified percentage of nominal interest earned and allow only the same percentage of interest paid to be deducted.

Depreciation. During inflation, depreciation deductions erode in value because they are spread over many years and are based on an initial cost that is measured in terms of the price level at the date of purchase. Depreciation indexing would adjust annual depreciation deductions to reflect changes in the price level from year to year. Any schedule of depreciation deductions could be indexed for inflation so that the real value of the deductions would not change with inflation. Indexation should be superimposed on the depreciation schedules that would be preferred in the absence of inflation.

Production Inputs Taken from Inventories. When goods are purchased in advance of their use in production, inventories accumulate and inflation causes problems. If the cost of inventory goods used in production is taken to be the nominal amount originally paid for them (as under current law), during inflationary periods the true cost of production is understated and consequently income is overstated and overtaxed.

Indexing inventories for inflation would require that purchase prices of goods be translated into the dollars prevailing at the time of their use. Most indexing advocates recommend explicit indexing coupled with first-in-first-out (FIFO) tax accounting.

Overall Merits of Indexing the Income Tax Base

Equity. Tax-base indexing, accompanied by repeal of all tax preferences, would improve the equity of the tax. Taxpayers with the same real incomes would pay the same rate of tax, regardless of the nature of their investments or the way their income was split between earnings from labor and capital.

Efficiency. If the income tax base was indexed for inflation and all savings and investment tax incentives repealed, investment dollars would flow to their best uses, as measured by the highest before-tax rates of return. The overall level of saving might fall, however, if the tax preferences were repealed. If only one or several of the tax-base items were indexed, or if indexation was not accompanied by repeal of existing tax preferences, the tax system would continue to distort the allocation of resources among investments.

Simplicity. Indexing the income tax base for inflation would complicate taxes, particularly for small businesses, individuals with capital income, and the IRS. The largest corporations, which already provide supplementary indexed income statement and balance sheet data for shareholders, would probably not face too much of an additional administrative burden. Repealing tax preferences for capital income at the same time could simplify taxes.

Revenue Effect. Indexing the income tax base without repealing tax preferences would cause a federal revenue loss. At least some of any loss could be recouped by repealing tax preferences. Indexing superimposed on the current tax would reduce taxes for individuals who have capital gain and interest income and would raise them for those who deduct interest payments. Homeowners with mortgages and businesses that had borrowed expecting to be able to deduct their entire interest payments could find it difficult to pay the additional tax.

TAXING CONSUMPTION INSTEAD OF INCOME

Since income is either spent or saved, an income tax with a deduction for saving is a tax on expenditure, or consumption. A consumption tax would be collected in much the same way as the current income tax, except that all saving would be treated similarly to deposits to Individual Retirement Accounts. Additions to saving would be tax deductible without limit, and withdrawals would be taxed in full unless reinvested. Withdrawals could be made at any time without penalty. Taxpayers would report all salaries, wages, dividends, interest, rental income, and proceeds from sales of assets. They would be allowed to deduct net additions to saving, such as deposits to savings accounts and purchases of stocks, bonds, and other income-producing assets.

Since borrowing is available for spending, it would be included in the tax base. Since repayment of debt is not available for spending, it would be deductible. If borrowing was not taxed, taxpayers would be able to profit by borrowing through saving the proceeds and taking a tax deduction for it, even though they had not changed their net saving.

A proportional consumption tax could be collected either in the manner just described or as a sales tax imposed on all final goods and services. It would be difficult, however, to make a sales tax progressive or to make it reflect differences in family size or other circumstances.

Equity

A consumption tax could be made as progressive as desired by enacting graduated marginal tax rates. For instance, tax rates could be set to replicate the progressivity of the current income tax.

Much saving and borrowing is done to smooth out annual consumption over a lifetime. For that reason, some feel that annual consumption is a better proxy for permanent lifetime income and hence a better tax base than is annual income. They reason that a consumption tax comes closer than an income tax to collecting equal amounts of tax from those with equal lifetime incomes. Proponents of consumption taxation argue that saving is taxed twice under an income tax: once when the income is initially earned, and again when the savings earn interest.

Since consumption is highest relative to income during youth and retirement, under a consumption tax, taxpayers would generally pay more tax in those years and less in midlife than under an income tax. Those who have saved early in life would pay less tax under a consumption tax than under an income tax. Unless taxed on their estates at death, extremely frugal people would pay little tax, even though they might have high incomes.

Some consider income to be a fairer base for taxation than consumption because they think a lifetime perspective is too long or because all income represents power to consume or save. Since all income could potentially be consumed, it is immaterial in this view whether income is in fact saved or spent.

Efficiency

Because money saved would not be taxed under a consumption tax, the return to saving would be exempt from tax. In other words, the after-tax return to saving would be the same as the before-tax return. Economic efficiency would be improved because the tax would not influence the decision to save, nor would it fall more heavily on some kinds of investment than on others, as the current income tax does. On the other hand, because saving would be deductible under a consumption tax, the base of a consumption tax would be somewhat smaller than the base of an equally comprehensive income tax. Therefore, tax rates would have to be higher (probably by 5 to 10 percent) than under an income tax, imposing greater distortions on the choice between leisure and working to finance current consumption, between untaxed fringe benefits and wage income, and between market and nonmarket work done to finance current consumption. Studies that have attempted to determine whether consumption taxation increases overall economic efficiency have reached conflicting conclusions, although most predict that a consumption tax would probably increase the saving rate and economic efficiency.

Simplicity

A consumption tax would greatly simplify tax accounting for businesses but not affect it much for average taxpayers. The corporate income tax would probably be abolished or retained in a simpler form. The costs of business plant, equipment, and raw materials would be deducted by the self-employed (and by corporations if a corporate tax were retained) in the year of purchase (expensed), rather than depreciated, rendering unnecessary the complicated depreciation and inventory accounting of current law and the indexation of depreciation and inventories for inflation. Since all the proceeds of the sale of assets would be available for consumption, it would all be taxed, obviating the need to differentiate between capital gains and other income and to index capital gains for inflation. Tax compliance could worsen, however, since the incentive not to report asset sales would be greater because tax would be due on the entire sale proceeds, not on just the capital gains.

Other Advantages and Disadvantages of Consumption Tax

Integration of Corporation and Individual Taxes. Integration of corporation and individual taxes would be easy to achieve under a consumption tax, since retained earnings not available for consumption would appropriately not be taxed. When retained earnings were reflected in higher proceeds from stock sales, they would be taxed under a consumption tax, and dividends would be taxed each year unless reinvested by shareholders. If the corporation income tax was abolished, however, revenue now raised from that tax would have to be collected under the individual consumption tax, requiring higher tax rates. Moreover, some favor retaining a corporation income tax because it makes the tax system more progressive or because it is a tax on the privilege of doing business as a corporation.

Remaining Problems. Some problems with the income tax would not be solved by a consumption tax. It would still be difficult to tax fringe benefits and nonmarket work, to decide whether to tax families or individuals, and to improve tax compliance.

Some new problems would arise with a consumption tax. During the transition, taxpayers could be taxed twice: first on savings made from income taxed under the income tax and again when they spent those savings to consume. Some people, current retirees in particular, could, therefore, face big tax increases. More generally, people who save little and consume early in their lifetimes would pay more in tax under a consumption tax, and savers would pay less. Moreover, since it would be easier to amass sizable wealth under a consumption tax, the concentration of wealth might increase, unless there were offsetting increases in estate and gift taxes or a new wealth tax were enacted. To the extent that special tax inducements to invest in particular ways were retained or exclusions enacted for certain kinds of consumption (housing, education, or medical care, for instance), some of the potential simplicity and efficiency gains of a consumption tax could be lost.

CONCLUSION

Although each major option for change--broadening the income tax base and reducing rates, indexing the income tax base for inflation, and taxing consumption instead of income--has much to recommend it, some major problems would remain under each approach, and the transitional costs of moving to any significantly different new tax could be great; the more different the new tax, the greater the costs. The Congress need not adopt any of these plans wholesale, but could instead make incremental changes, such as repealing selected tax preferences, to move gradually toward one of the prototypes.